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SUBJECT: CZECH REPUBLIC'S DISAPPOINTING REVISED EURO
ADOPTION STRATEGY

REF: PRAGUE 1201

¶1. (SBU) Unlike in some countries where euro-adoption serves as a carrot to drive and provide political cover for difficult reforms, the Czech euro adoption strategy remains hostage to Czech domestic politics. While key export-oriented industries continue to lobby hard for euro adoption at the earliest possibility, the average Czech citizen is at best apathetic and at worst fearful that euro adoption will mean even faster acceleration in the cost of living. Louder than industry lobbyists has been President Vaclav Klaus, a well-known euro-skeptic. Last week, Prime Minister Topolanek joined Klaus by stating to the local equivalent of the Wall Street Journal that he rejects calls from industry to establish a firm target date for euro adoption, citing public skepticism about adopting the euro. Topolanek took a difference approach in explaining his position to the international press. In a November 11 interview with the Financial Times, he said the Czech Republic is in no hurry to join the eurozone until further economic reforms (i.e., healthcare and pension) are completed. He also said his government wants to study whether eurozone states enjoyed lower inflation and faster growth than those outside, and whether his country had the labor flexibility to join without damaging the economy.

¶2. (U) The Czech Republic initially hoped to adopt the euro in 2009-2010. However, continued lack of structural reforms combined with enthusiastic politically-motivated government spending in the run-up to the 2006 general elections significantly deteriorated public finances in 2007, resulting in the Czech National Bank and the Ministry of Finance jointly issuing on August 29 the "Updated Euro-Area Accession Strategy," which delays the euro adoption timeline to 2011-2012. The Czech Republic will have to join ERM-II during 2008, if it is going to meet the 2011 target. However, as the revised Czech euro adoption strategy says, further consolidation of public finances is not possible without serious reforms (i.e., pension and healthcare).

¶3. (SBU) Private sector economists expressed general disappointment with the revised strategy, saying that it points out the obvious obstacles to euro adoption without outlining how they will be tackled, and casting serious doubt on the likelihood of its implementation. One economist summarized the nine-page document as follows: "In order to benefit from the euro adoption, we need to be able to replace the loss of domestic monetary policy with something else. This would be a stabilizing fiscal policy and flexible labor market. This is not in place now, so let's wait until it gets better. The government says that the next phase of economic reforms will go in this direction." The joint government-Czech National Bank strategy paper can be found at: www.cnb.cz/en/monetary policy/strategic documents/

download/eurostrategy 070829.pdf

¶4. (SBU) In light of its aspirations to join the eurozone, the Czech Republic has pledged to Brussels three things: (1) continued decrease in general government deficit; (2) 2008 deficit will not be over 3%/GDP; (3) deficit will not be higher than 1%/GDP by 2012. Revised data released by the Czech Statistical Office on October 1 showed that the 2006 public finance deficit dropped to 2.69%/GDP from 3.49%/GDP in ¶2005. External sovereign debt also fell from 30.24%/GDP in 2005 to 30.11%/GDP in 2006. This means that in 2006, the Czech Republic met its Maastricht criteria. The state budget was in surplus at end-September, but expenditures tend to accelerate in the last quarter of the year and the public finance deficit for 2007 is projected at 3.6%/GDP. So the Czechs will need to get back on track starting with the 2008 budget, the details of which are reported in reftel.
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